

# Private Equity and the Insurance Industry: A Close Look at a Natural Partnership

## State of the Market

Private equity sponsors are playing an increasingly important role as managers of insurance company assets, which has implications for both the insurance M&A market and the private equity fund investment space.

The reason for this development can be traced to the insurance company business model, in which premiums are received from policyholders and invested for a period of time, before eventually paying out much of the premium amount in claims and expenses. In the case of an insurer that pays out roughly the same amount in claims and expenses as it receives in premium revenue, the premium revenue represents, on an aggregated basis, a zero coupon loan for the average duration between the receipt of the premium and the payout of claims. For life and annuity insurers especially, the average time period between the receipt of premiums and the payouts of claims can be many years, meaning that an insurer's profitability will be driven in large measure by its success investing the premiums it collects.

## Insurance M&A

Private equity sponsors are natural acquirers of insurance businesses. Insurance companies are required by state insurance regulators to hold significant amounts of assets on their balance sheets in order to fund future liabilities that may arise under the insurance policies they have issued. Particularly in the case of life and annuity insurers, these future liabilities are long dated and can be backed with less liquid asset strategies. An acquisition by a private equity sponsor of an insurance business creates the opportunity for the sponsor to increase the insurance business' return on investment which, as noted above, is a key driver of profitability.

## Fund Investments

Because insurance companies hold large pools of assets in order to fund often long dated future liabilities, they need capital-efficient ways to manage and invest those assets. As a result, insurance companies often make natural investors in alternative asset strategies, such as the purchase of limited partner interests as well as other bespoke solutions offered by private equity sponsors. The specifics of how any particular investment is structured, of course, can have significant implications under the capital regimes to which insurers are subject.

## M&A Developments

Private equity sponsors—including Apollo Global Management LLC, The Blackstone Group (“Blackstone”) and The Carlyle Group (“Carlyle”)—have been involved in a significant number of public company deals involving life and annuity companies. As with the investing synergies described above, this reflects the intersection of interests between private equity and insurance: Insurance companies seek profitable growth through enhancing their investment management capabilities, while private equity sponsors need access to the “permanent” investment management opportunities that can be provided by an insurer with an ongoing stream of new premium revenue.

A recent example is provided by the acquisition in late November 2017 by CF Corporation (an acquisition vehicle backed in part by private funds affiliated with Blackstone) of Fidelity & Guaranty Life for \$1.835 billion. In connection with this transaction, Blackstone entered into an arrangement with Fidelity & Guaranty Life to manage its approximately \$25 billion investment portfolio.

Another recent example is the announcement on August 1, 2018 by American International Group, Inc. (“AIG”) and Carlyle of a strategic partnership in which Carlyle acquired 19.9 percent of DSA Re (a reinsurer established by AIG that reinsured legacy insurance business issued by AIG) and entered into a strategic asset management relationship with the reinsurer. Similar to the acquisition of Fidelity & Guaranty Life, this transaction gave Carlyle access to a large pool of assets that will benefit from Carlyle’s asset management expertise, as well as a possible platform for the acquisition of other insurance business.

## Fund Investments

With the assets that insurers have on hand to invest at an all-time high, sponsors have been hard at work developing scalable products and structures to cater to the regulatory, tax and other requirements of their existing and prospective insurance company clients. U.S. insurers, for example, are particularly concerned about the effect an investment will have under the risk-based capital (RBC) regime to which the insurer is subject. Under these regimes, U.S. insurers typically face substantially higher capital charges when investing in limited partner or other common equity interests than when investing in rated debt or rated preferred equity interests.

One product available to address insurance company RBC charges is a feeder or parallel vehicle that issues “rated” debt (as well as some equity) to insurers, with the debt portion of the investment producing substantially lower RBC charges than limited partner interests, particularly where the underlying investments are in credit products. The debt issuer may be a dedicated feeder for a particular fund or may be part of a “collateralized fund obligation” structure that invests in a variety of products. Another scalable approach to reducing RBC charges is for insurers to use their general accounts to take out life insurance policies with

other insurance writers, which in turn invest the premiums in insurance dedicated funds (“IDFs”) comprised only of insurance company investors. In this case, the insurer holding the insurance company owned life insurance (“ICOLI”) policy ultimately benefits from the investment performance of the IDF and the writer of the policy receives premium income for its part in the arrangement.

Of course, while sponsors are increasingly focused on scalability, they nonetheless continue to provide tailored solutions to address insurers’ RBC concerns, such as co-investment accounts that provide for the client to hold debt instruments directly in lieu of limited partner interests.

Even when primarily driven by RBC considerations, insurance investment structures often pose a variety of tax issues that sponsors must navigate. For rated debt arrangements, parties will want to ensure that the issuer does not pay entity-level tax. New limitations on deductions for interest expense under recent tax reform legislation also pose complications for issuers, although proposed regulations provide some welcome clarifications. ICOLI arrangements must satisfy a variety of technical tax rules to ensure that the policy delivers the favorable treatment U.S. tax law affords life insurance. For example, the investments backing the policy must meet a diversification requirement (which “looks through” an IDF to its underlying investments, but only if certain requirements are satisfied). Moreover, the insurance company buying the policy must not have formal or informal control over investments by the ICOLI writer (e.g., the ICOLI investor generally cannot communicate with the fund sponsor).

As these products and structures are refined and continue to gain prominence, sponsors will be able to offer a more sophisticated set of options to insurers that are increasingly willing to invest in less liquid assets in exchange for the potentially higher yields sought by core private equity strategies.

## Regulatory Considerations

### Insurance M&A

Insurance M&A typically takes one of two forms: (1) acquisition of an insurance company or (2) reinsurance of insurance liabilities to an existing insurance platform (which a sponsor can only do if it already has access to a licensed reinsurance company).

If the transaction involves the acquisition of a U.S. insurance company, the transaction will be subject to approval from the state insurance regulator of the target’s domiciliary state. While many state insurance regulators have become more comfortable with private equity buyers in recent years, they still draw heightened scrutiny relative to other financial institution buyers. As part of the state insurance regulator approval process, sponsors will be required to provide information about their controlling persons, as well as share a business plan detailing how the sponsor plans to run the business after closing of the transaction. In connection with the approval, regulators may impose certain conditions on the sponsors, such as (a)

maintaining a minimum RBC ratio at the target company after closing of the transaction (potentially including a requirement that some amount of assets be held in trust in order to maintain that minimum RBC ratio) or (b) a restriction on dividends that can be issued by the target company without regulatory approval for a certain period of time after closing of the transaction. As in any M&A transaction, non-insurance approvals or non-disapprovals or expiration of waiting periods may be required, such as expiration of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, or approval by the Committee on Foreign Investment in the United States.

If the transaction takes the form of reinsurance, whether regulatory approval is required prior to the transaction becoming effective depends on the laws of the domiciliary states of the target company and the acquiring company. If required, the approval process typically takes less time than the approval process in connection with an acquisition of an insurance company, and approval is less likely to have conditions associated with it.

### **Fund Investments**

Unlike insurance M&A deals, insurance regulators do not typically have the right of prior approval over fund investments. One important exception is in the case of a material investment by an insurer into a fund or strategy managed by an affiliated fund sponsor, in which case prior insurance regulatory review will typically be required. Of course, in all cases such investments need to comply with applicable law, which, for insurance companies, contain both qualitative and quantitative limits on permissible investments.

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